Mobilizing ¥1700 Trillion

The Case for Active Stock Selection in Japan

Timothy R. Doyle | February 2026

Executive Summary

The investment case for Japan in 2026 is defined by a massive structural event that is taking place:

The continued mobilization of ¥1700 Trillion in investable capital.

Deflationary forces persisted in Japan during the three decades following the 1989 bursting of the Nikkei bubble, incentivizing households and corporations to hoard cash. Since the shock of COVID, modest inflation has become sticky. The BOJ responded by keeping real rates negative, purging the deflationary mindset from *both* households and corporations. Capital – both corporate and household—is being forced into more productive areas due to the pain of negative real rates. Simultaneously, the latest METI/TSE capital efficiency initiatives are unlocking shareholder value and NISA initiatives targeting tax-advantaged accounts are providing the path for Japanese households to participate in the potential domestic shareholder windfall.

But macro and structural tailwinds do not guarantee returns at any price.

With the TOPIX having advanced significantly—up ~34% in the last 12 months alone—and trading at a trailing P/E of 19.8x (January 2026), the blanket "Japan is cheap" thesis is no longer a given. The headline index appears to largely reflect the good news.

The opportunity has moved primarily to active stock selection.

Through targeted screening—the enterprising investor can still uncover value in two specific areas: **Domestic Compounders,** and **Bargain Issues.** Additionally, both strategies offer an embedded free call option on yen reversion.

> ***"I think I've been in the top five percent of my age cohort almost all my adult life in understanding the power of incentives, and yet I've always underestimated that power."***[1]
>
> **— Charlie Munger**

The Investment Framework

The Japan of 2026 is experiencing a *generational* capital reallocation—¥1,100T in household deposits as well as ¥600T in corporate capital accumulated as cash, marketable securities, and cross-shareholdings is being forced into motion by a wide range of underlying factors.

Understanding where the opportunity lies requires examining the three distinct forces driving the movement of capital and the subsequent re-pricing of Japanese equities:

- **Force #1 - Macro Catalysts:** Negative real rates, yen undervaluation, and labor scarcity.
- **Force #2 - Structural Reforms:** METI/TSE governance reforms and NISA tax incentives.
- **Force #3 - Corporate Fundamentals:** Pricing power and fortress balance sheets.

These three forces work sequentially: Macro forces put the capital into motion → Structural reforms direct how the capital flows → Corporate fundamentals dictate where the capital flows will end up.

These forces are measurable, directional, and converging. The question is not whether capital is being reallocated—that process has already begun. It is whether stocks offer asymmetric risk/reward at current valuations.

We begin with the macro catalysts.

Force #1: Macro Catalysts

The Convergence

The mobilization of ¥1,700 trillion is not a random event. It is a rational economic response to three converging macro drivers.

Individually, any of these forces is disruptive. Together, they create a structural environment that destroys the utility of cash and compels redeployment of capital into risk assets:

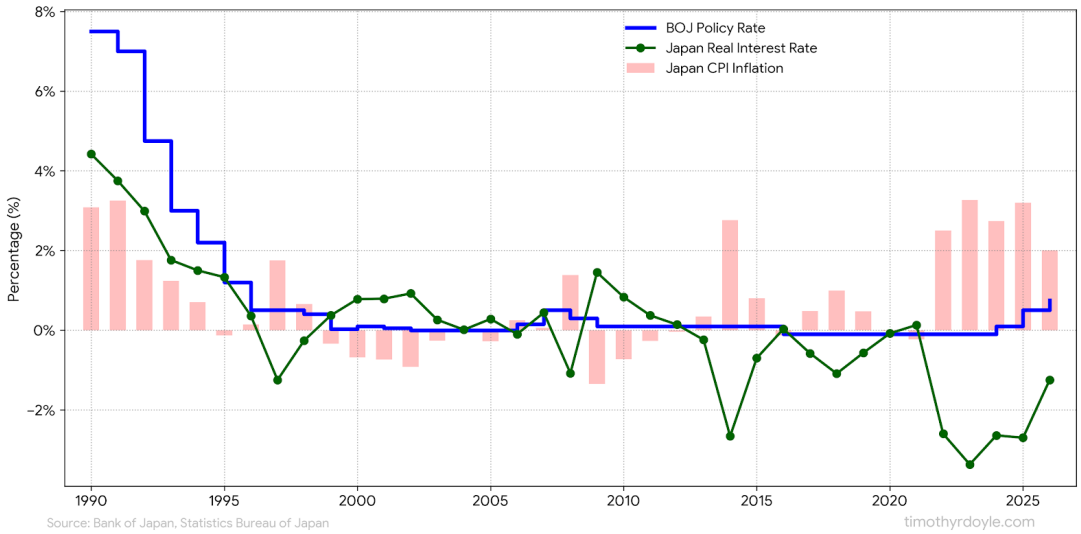
- **Negative Real Rates:** The Penalty on Cash
- **Yen Undervaluation:** A Stress Test of Pricing Power
- **Labor Scarcity:** The Incentive for Automation

First, the power of negative real rates.

I. Negative Real Rates—The Penalty on Cash

Japanese real rates in the post-COVID era have been *more* negative (**Figure 1**) than at any point since the 1990 Nikkei bubble burst. While the US Fed has begun easing, the BOJ has deliberately kept the policy rate well below inflation—a strategy designed to purge *three decades of deflationary psychology* and to establish inflationary *expectations* as the new normal.

Figure 1: BOJ Policy vs. Japan CPI - BOJ Interest Rate Policy[2]

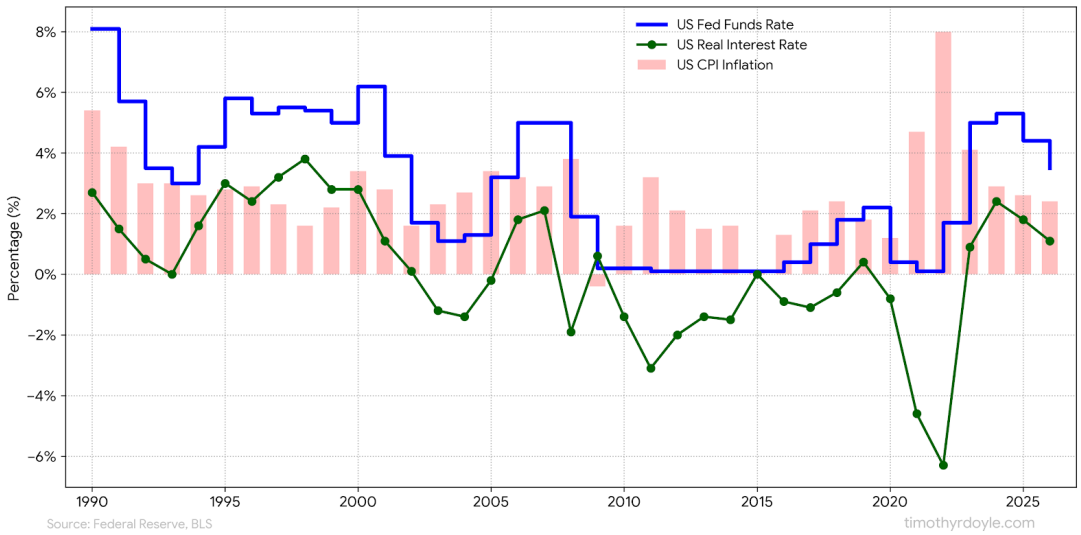


The Reflation Playbook

The BOJ's strategy mirrors Fed Chair Ben Bernanke's post-GFC "reflation" playbook. Bernanke—a student of the Great Depression and Japan's 1990 policy errors—used aggressive quantitative easing to drive real interest rates modestly negative during the early 2010s (**Figure 2**), forcing capital out of cash and into risk assets.

Japan failed to do this in 1990. Positive real rates incentivized cash hoarding. Today, the BOJ is correcting that policy error. By making it expensive to hold cash, the BOJ is effectively forcing households to transition from passive savers to active investors. This push applies equally to corporations, where an inflationary "tax" is particularly painful for companies hoarding cash, nudging them toward more productive uses of idle capital.

Figure 2: Fed Funds vs. US CPI - US Interest Rate Policy[3]



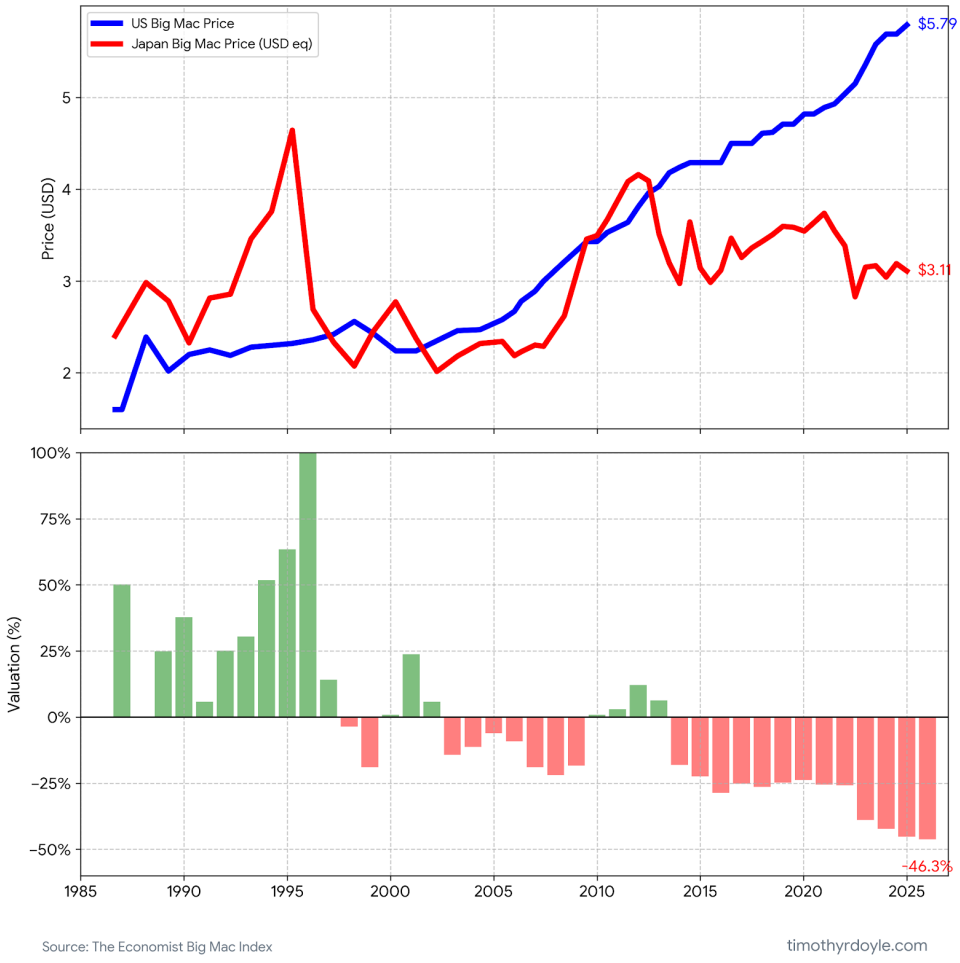
II. Yen Undervalution—A Stress Test of Pricing Power

The yen—trading around ¥154 per USD—is undervalued relative to historical metrics. This dislocation stems from a decade-long policy divergence: By the early 2020s, the Fed had raised rates to 5%, while the BOJ held nominal rates flat, allowing inflation to push real rates even more negative. This fueled a "carry trade" that sold yen and bought Dollars.

Purchase Power Parity Dislocation—The Big Mac Story

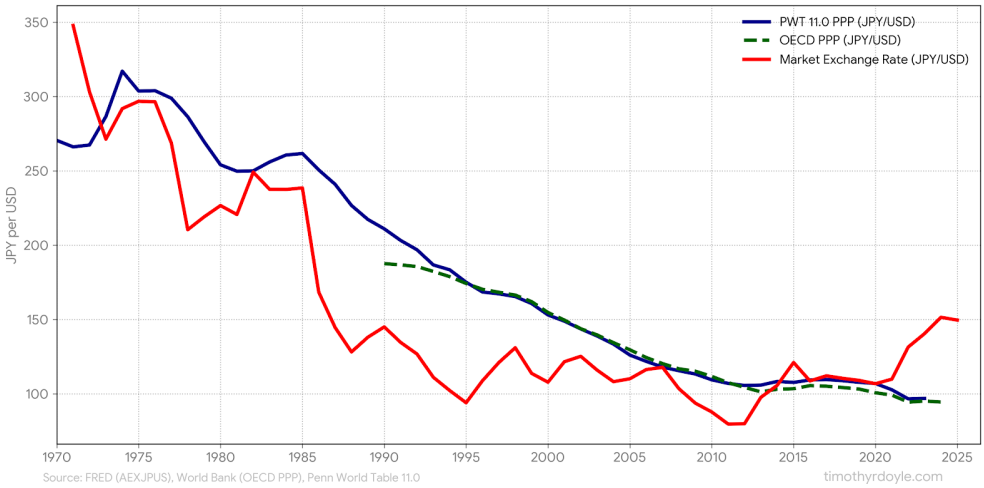
The most relatable evidence of the undervaluation is the Purchase Power Parity (PPP) disparity, as illustrated by the ultimate American symbol of "Bigger is Better"—The Big Mac. *The Economist* magazine developed The Big Mac Index in 1986 to compare the price of a Big Mac across different countries. A Big Mac is functionally identical in Tokyo and New York. **Figure 3** shows the pricing data. In USD terms, the price of a Japanese Big Mac has flatlined for 30 years, while the American Big Mac price has more than *tripled*.

Figure 3: The Big Mac Index (US vs Japan)[4]



In an efficient market, identical goods should cost roughly the same in USD. When they do not, the currency is mis-priced. As **Figure 4** confirms using OECD and Penn World Table data—the yen is currently trading at a multi-decade undervalued deviation.

Figure 4: JPY/USD & PPP Estimate[5]



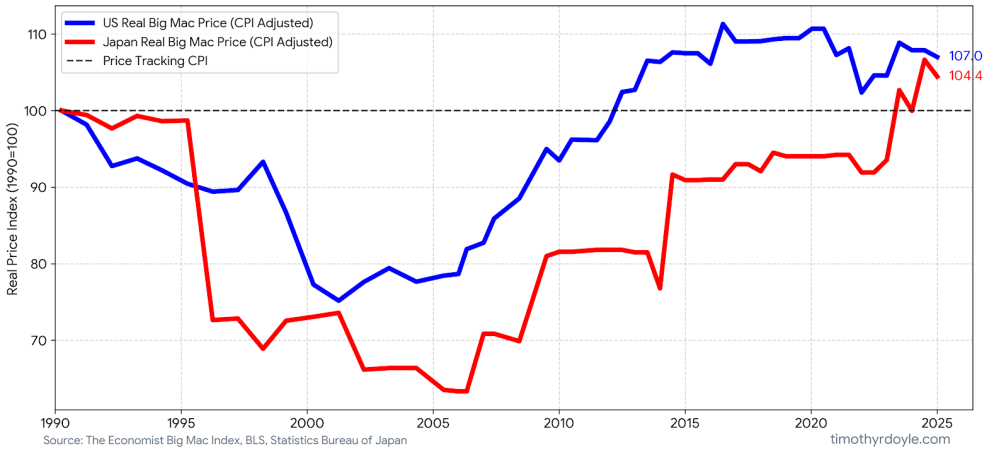
The Embedded Call Option

This creates a unique valuation asymmetry. You cannot buy 10,000 Big Macs in Tokyo and sell them in New York, but you *can* exploit this pricing gap through Japanese equities. Buying domestically focused Japanese equities provides an embedded call option on the yen. If the currency mean-reverts, the USD investor captures a currency multiplier on top of equity returns. At a minimum, the extreme yen undervaluation provides a historic margin of safety.

Pricing Power

Figure 5 reveals a critical insight obscured by a weak yen. To USD observers, Japanese prices look stagnant. However, in yen terms, McDonald's Japan has demonstrated significant pricing power since 2006, raising prices faster than domestic CPI. Even *more* impressive has been able their ability to pass on rising input costs even when the yen has *weakened* further—an indication that this is a business with excellent pricing power.

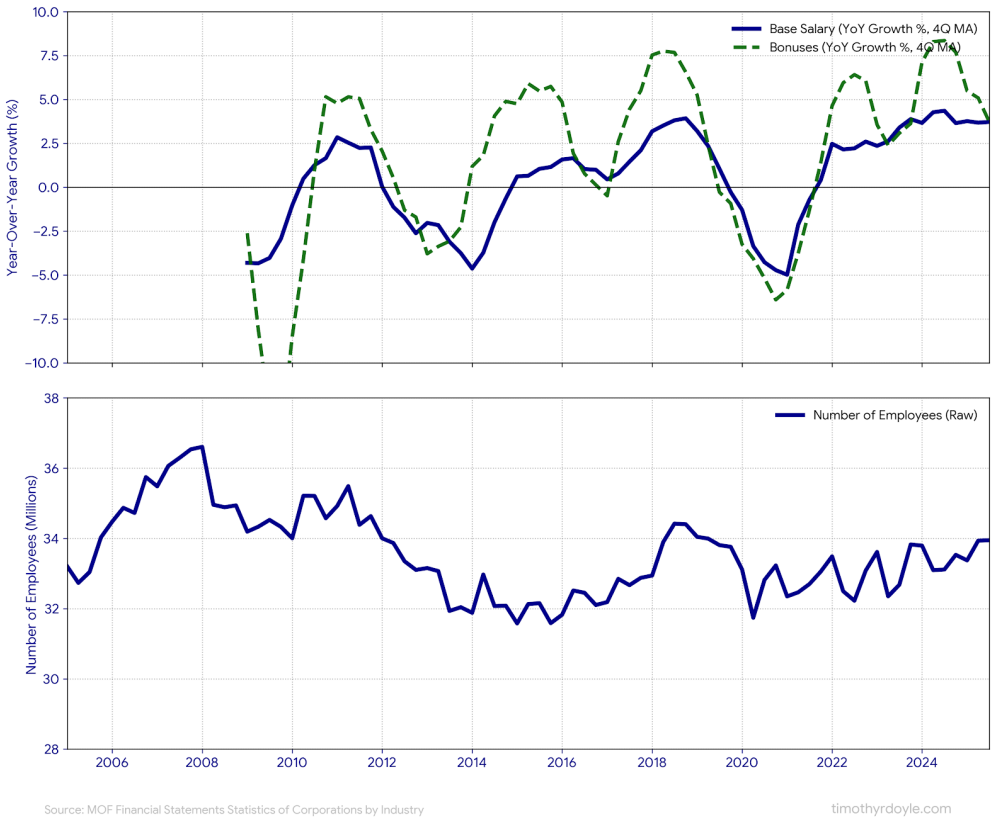
Figure 5: Big Mac Real Pricing Power (local currency vs CPI)[6]



III. Labor Scarcity—The Incentive for Automation

The third macro force is demographic and irreversible: Japan's labor pool has shrunk 8% since 2008, forcing companies to compete for scarce labor (**Figure 6**). This scarcity has forced nominal base wages up 4.7% (Q3 2025)—the fastest pace in decades—even as real wage growth remains negative.

Figure 6: Rising Nominal Wages Meet a Shrinking Workforce[7]



The Productivity Imperative

This creates a permanent productivity crisis. Corporations can no longer solve problems by adding headcount. Automation is not optional for companies wishing to grow. The labor squeeze forces the movement of capital into CapEx, software, and automation.

Combined with negative real rates (the penalty on cash) and wage inflation (forcing price increases), labor scarcity is the final nail in Japan's deflationary coffin, forcing a capital efficiency cycle that the Tokyo Stock Exchange is now demanding.

Force #2: Structural Reforms—The Mechanisms

The Great Divergence - Households vs. Japan Inc.

To understand the magnitude of the available capital, one must understand what has happened over the last three decades within Japan.

The bursting of the 1990 bubble created a massive divergence between the wealth of the Japanese Household **(Figure 7** and **Figure 8)** and that of the Japanese Corporation **(Figure 9).**

While households suffered a "lost generation" of wealth *destruction*—seeing land values vaporize from ¥1,780 Trillion to just ¥1,158 Trillion (in 2020 yen), Corporate Japan used the exact same period to transform itself. In a deflationary environment that kept wages relatively flat, corporations grew real retained earnings by 345% (from ¥130T to ¥579T), built cash reserves, and obtained equity through cross share holdings.

But recently, cash security has also evaporated. For households especially—which still hold ~**50**% of their financial assets in cash—the return of moderate inflation has had a visible impact on household wealth. Since 2021, **Figure 8** shows that the real value of household cash *declined* from ¥1,068T to ¥1,000T even while nominal cash savings *grew*—the very definition of pain.

Figure 7: Japan Household Wealth in *Nominal* Terms[8]

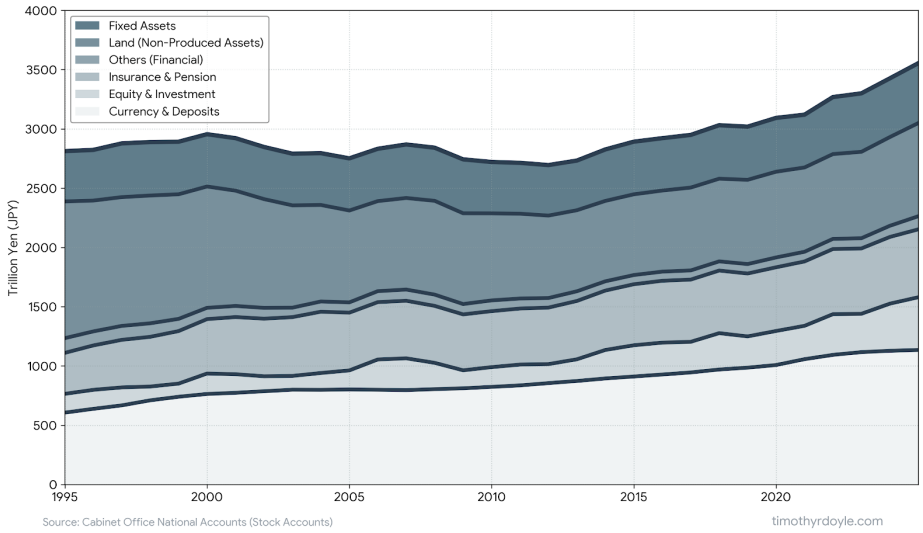


Figure 8: Japan Household Wealth in *Real* Terms[9]

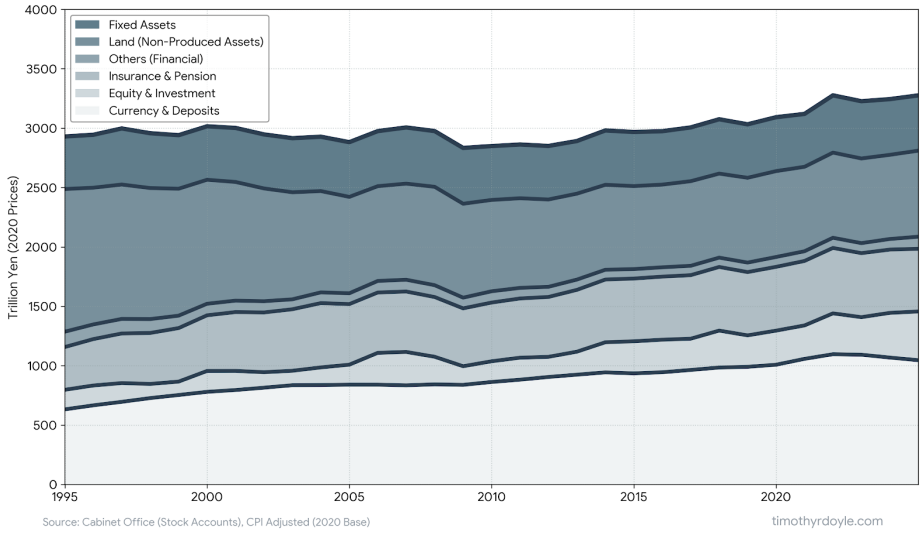
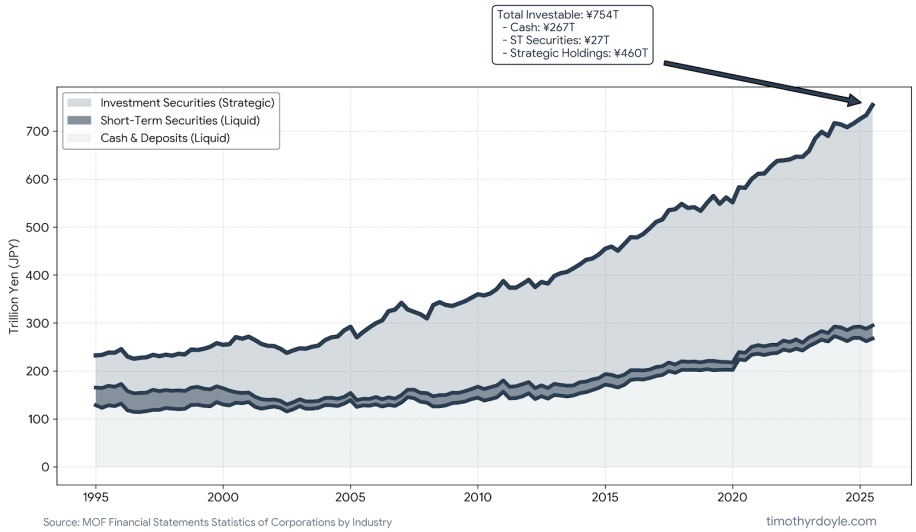


Figure 9: Japan Inc. "Value Vault" Liquid Assets[10]



The Rationality of Stagnation

For decades, hoarding cash was not financial illiteracy; it was a survival strategy. BOJ Policy Board member Hajime Takata noted in an October 2025 speech[11] that household risk aversion was "completely rational" under the old lifetime employment system. Cash was the hedge against a deflationary economy where salaries were stagnant but employment was implicitly guaranteed.

Today, that social contract is broken. With inflation returning and lifetime employment eroding, the "rational" move has flipped from saving to investing. Takata notes that for the first time, "Japan is finally equipped with the two wheels of the cart, with both institutional factors and economic conditions allowing for successful investment experiences."

The Household Vault—NISA incentives

To capture these improving corporate returns, the government has expanded the NISA (Nippon Individual Savings Account) program.

A New Generation of Investors

Adoption is being driven by a generational divide. While older generations suffer from the "lingering trauma" of the bubble burst, younger investors are unscarred. Data cited by the JPX shows that "48.8% of the NISA accounts and 44.6% of the investment money are held by people in their 40s and younger."[12] This is a cohort that views inflation, not deflation, as the primary threat to their wealth.

Addressing the "Capital Flight" Risk

One may argue that NISA is a net negative for the yen, funneling Japanese savings into US Tech stocks and other global assets. While it is true that passive NISA flows favor global indices, the active component ("Growth Quota") reveals a strong home bias:

Approximately 40% of these active investments—more than ¥10 Trillion—have flowed into individual Japanese stocks, primarily high-yield dividend payers.[13]

Even with a significant amount of NISA account funds being invested globally, the sheer scale of the mobilization means the absolute yen amount hitting the TSE is a massive marginal buyer for small-to-mid-cap valuations.

Early Innings

Interestingly, this re-rating has occurred with only 2.6% of household assets shifting from savings to investment (¥31 Trillion total). This low penetration rate is not a failure but instead a measure of the massive "dry powder" still sitting in zero-yield accounts.

The Corporate Vault—METI & TSE Reforms

The catalyst for unlocking the corporate balance sheets is the Tokyo Stock Exchange (TSE). In 2023, they moved from passive observation to active enforcement, targeting companies with a Price-to-Book Ratio (PBR) below 1.0x.

The "Name and Shame" Regime

This is not just words; the data confirms a behavioral shift:

TOPIX Exits: In 2025, a record 124 companies delisted—choosing to go private rather than face public scrutiny.

Unwinding of Cross-Shareholdings (Mochiai): The fuel for this shareholder return boom is the unwinding of "Mochiai". Under pressure to improve capital efficiency, corporations are liquidating passive stakes in partner companies and redirecting that cash into buybacks. Although non-recurring, this structurally boosts ROE.

Record Buybacks: Share repurchases hit ¥18 Trillion in 2024 (up from ¥9.6T in 2023) and were projected to exceed ¥20 Trillion in 2025.

Compliance: As of July 2025, 90% of Prime Market companies had disclosed explicit plans to improve their P/B ratios.

Aligning Management with Shareholders

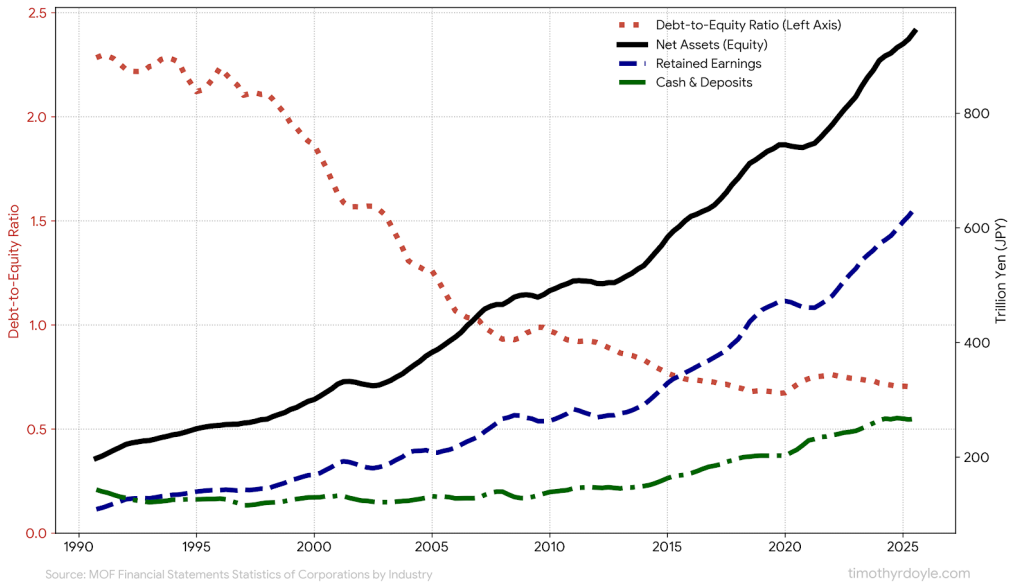
There is also a quiet revolution happening in the boardroom. JPX (Japan Exchange Group) CEO Hiromi Yamaji highlighted in a November 2025 presentation[14] that stock-based compensation has more than doubled, from 14% of executive pay to 33%. Management is no longer just "shamed" into raising stock prices; they are now even more incentivized to do so.

The Structural Pivot is Happening

As **Figure 10** illustrates, the transformation of the corporate balance sheet is obvious—debt has been eliminated while equity and cash levels have soared. This "Fortress Balance Sheet" is now being targeted for shareholder returns.

Japan has successfully pivoted from a savings-based economy (funding low-return debt) to an Investment-based economy (seeking risk-adjusted returns). The "Value Vault" is open.

Figure 10: Japan Inc. Balance Sheet—Debt Collapses as Equity & Cash Soar[15]



Is The Pivot Priced In?

The evidence from the Macro Catalyst and Structural Reform trends is unambiguous: These forces incentivize capital flow from cash into risk assets. Even a modest 5% reallocation of the ¥1,700 Trillion represents ¥85 Trillion seeking returns.

This still does not guarantee attractive returns at any price. If the market has already fully priced in the "success" of these actions, then investors paying 19.8x P/E are betting on earnings growth that Japan Inc. has rarely sustained.

The critical variable is not just flow, but also valuation. To determine if the opportunity is already priced in, we must look below the surface of the index.

Force #3: Fundamentals—Fully Priced In?

Pricing Power—The Profitability Pivot

In the aftermath of the 1990 bubble, Japanese corporations played defense in a deflationary world. With the return of modest inflation, Japan Inc. has regained a critical missing lever: Pricing Power.

The Inflation Paradox

To outsiders, Japan's 2-3% CPI appears "modest"—a welcome normalization. However, domestically, it represents a cost-of-living shock. For a Japanese household conditioned to thirty years of stable prices, this is not a statistical adjustment; it is a psychological crisis that has shattered the deflationary social contract. Real wages have trailed inflation for several years, and household spend on food has hit 1980s highs.

This pain is now the catalyst. The sheer shock of asset erosion provides the inertia to force the ¥1100 Trillion of household cash off the sidelines, while simultaneously granting corporations the "social license" to raise prices for the first time in a generation. And corporations are exploiting this crisis to reset pricing permanently.

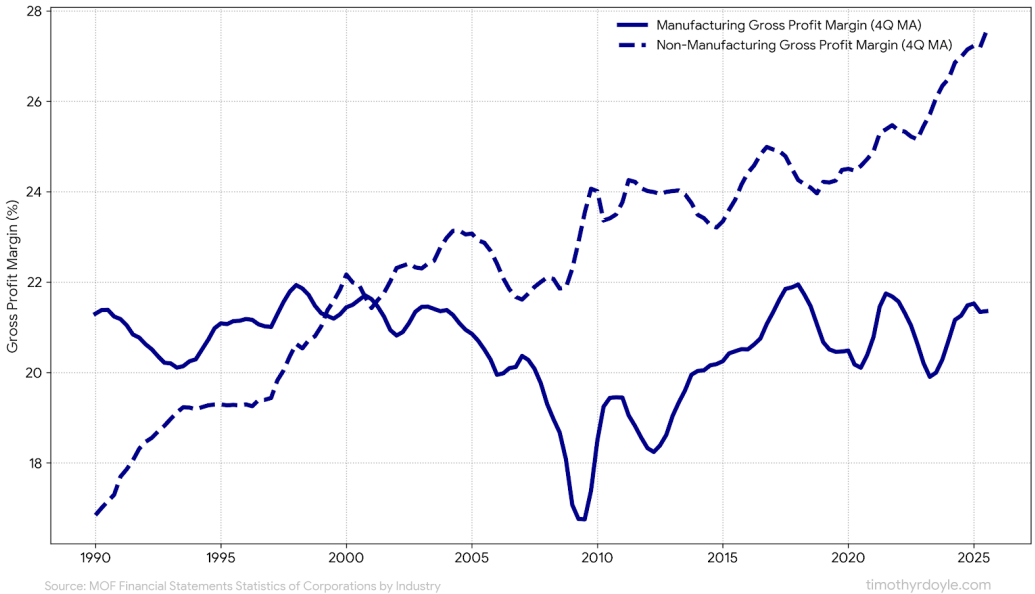
The Proof is in the Margins

The evidence that corporations are capitalizing on this shift is found in two distinct breakouts:

I. Gross Margins (The Pricing Power Test)

The true test of pricing power is the ability to pass on rising input costs. As **Figure 11** illustrates, Japan Inc. faced a significant "Cost-Push Shock" from 2021-2023 driven by a weak yen and commodity inflation. In previous cycles, this crushed profitability. This time, margins held firm (Manufacturing) or hit record highs (Non-Manufacturing), proving that the new inflation is flow-through, not margin-compressive.

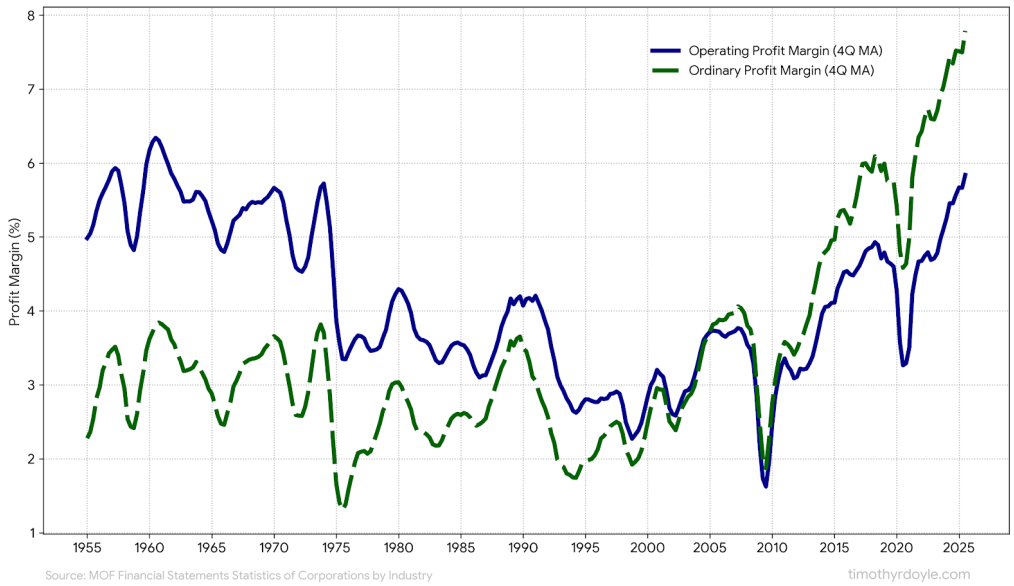
Figure 11—Japan Gross Profit Margins (1990—2024)[16]



II. Ordinary Profits (The Hidden Yield)

Standard Operating Margins tell only half the story. The true breakout is in Ordinary Profits—a Japanese GAAP metric that includes operating profit plus non-operating income (dividends, interest). As **Figure 12** illustrates, this profitability wedge—fueled by the fortress balance sheets—has surged to nearly 8%, a post-WWII high. Investors focused solely on Operating Income miss this "Hidden Yield" that supplements the regular earnings power of Japan Inc.

Figure 12—Ordinary Profits Break Out Above Operating Profits[17]



The Valuation Illusion

At first glance, these fundamentals seem priced in. The TOPIX currently trades at a P/E of 19.8x (January 2026), suggesting that the "Japan trade" is crowded.

However, the composite multiple is deceptive. It is an aggregate that blends high-flying semiconductor hype with lower multiple industrial leaders. There are also a plethora of small companies not part of any passive flow demand due to their minuscule size. The passive beta trade—where a rising tide lifts all boats—appears to have largely played out. What remains is a market of individual stocks, where the opportunity has migrated from the index level to active stock selection.

Is This a Bubble? (1989 vs. 2026)

With the TOPIX up ~34% in the last year and eclipsing bubble-era highs, the question is inevitable: Is this 1989 all over again?

The psychological scars of the 1989 burst—even more than 35 years later—are still pervasive. In the previously mentioned October 2025 BOJ policy speech, Takata invoked the term "bubble" *sixteen* times. This trauma is invariably anchored to one number: The Nikkei 225.

However, the Nikkei 225 is a flawed metric—a price-weighted index that severely distorts the reality of the modern economy (see **Appendix A** for a detailed breakdown). For this assessment, we rely exclusively on the TOPIX, a market-cap weighted index that captures the true breadth of Japan Inc.

The 1955 Parallel: Fear of the "All-Time High"

Before addressing the valuation question, it is instructive to look at a strikingly reminiscent moment in American history. It is the story of a nation that—still haunted by the past—paused to debate whether "new highs" and a rapidly ascending market meant that another crash was possible.

> The year was 1955. The Dow Jones had advanced significantly in the prior 18 months—up 44% in 1954 alone. The US Congress took notice. Fear of a 1929 repeat prompted Senators, led by J. William Fulbright, to commission a Stock Market Study, which culminated in Senate hearings.
>
> Among those who testified was Benjamin Graham, the father of value investing. In oral testimony on March 11, 1955, he addressed three factors: "the present level of stock prices from the standpoint of the relationship between price and value. Secondly, causes of the rise in the market since September 1953; and thirdly, feasible methods of controlling excessive speculation in the future." Graham's assessment: **"leading industrial stocks are not basically overvalued, but they are definitely not cheap; and they are in danger of going over into an unduly high level."**
>
> In his written statement—often misquoted—he provided a more memorable summary:
>
> ***"With regard to the present level of stock prices, common stocks look high and are high, but they are not as high as they look."***[18]
>
> **— Benjamin Graham, 1955**

Overall, the hearings could be summarized as much ado about nothing. A market that was largely trading within a range of reasonableness was experiencing some degree of speculative behavior, but not anywhere near levels seen—and greatly incentivized—in 1929.

1989 vs. 2026—The Tale of the Tape

Japan in 2026 is Graham's view of the US in 1955. While nominal prices are high, valuations are not as high as they look.

The Bubble vs. The Recovery

Metric	1989	2026	2026 Assessment
P/E Valuation	60x – 70x	**19.8x**	Normalized
Earnings Yield	1.5%	**5.0%**	Attractive
10Y Bond Yield	5.7%	**2.25%**	Supportive
Equity Risk Premium	-4.2%	**+2.75%**	Rational
Debt/Equity	2.2x	**0.6x**	Fortress

The comparison is unambiguous. In 1989, investors paid 60x earnings to earn 1.5%. Today, they pay 19.8x to earn 5.0%. The risk premium has completely inverted.

The Valuation Reality Check

However, at 19.8x earnings, the TOPIX is not cheap. It prices in a base case where:

- **ROE remains at or above 8%** (vs. historical 6-7%)
- **Governance reforms are permanent** (not a one-time sugar high)
- **EPS grows 4-5% annually** (automation + pricing power)
- **The yen remains weak** (no currency reversion headwind)

This implies a ~9.5% expected return (~5.0% yield + ~4.5% growth), but with zero margin of safety against a recession or policy error.

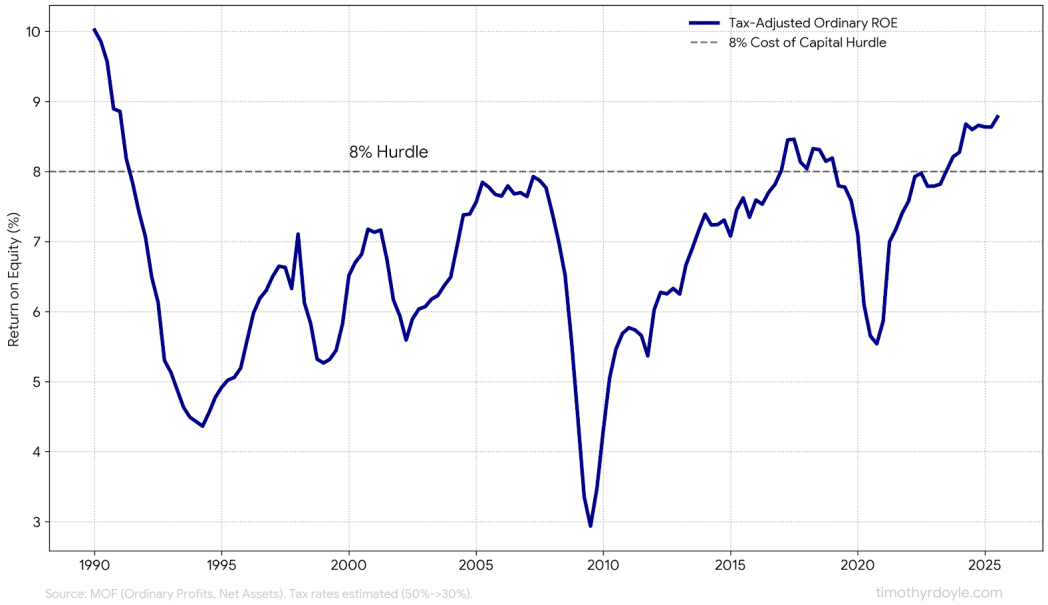
For the enterprising investor desiring a 10% hurdle rate with downside protection, the passive TOPIX is unattractive.

ROE—The Critical Variable

Why is the market granting this generous multiple? Because the earnings quality has changed. **Figure 13** provides the answer. When we adjust for taxes to view the "Real Net ROE", we see that corporate Japan spent the better part of the last three decades stuck in the "Underperformance Zone"—generating returns below the 8% cost of capital.

The recent breakout above 8% validates the structural reforms are working. Japan Inc. *may* have finally cleared the hurdle, transitioning away from being a value trap and to a value creating environment.

Figure 13—Real Net ROE for Japan Inc.[19]



Can 8% Be Sustained?

In the post bubble era, Japanese net ROE has *never* sustained above 8% for more than a year or two. However, this time the drivers are structurally different:

- **Coercive Capital Allocation**: The TSE's "name and shame" regime acts as a de facto enforcement mechanism. Buybacks hit ¥20T in 2025. Management teams are no longer hoarding cash to survive a crisis; they are deploying it to survive the governance crackdown. The threat of losing "Prime" status is the stick that ensures capital efficiency continues.
- **Balance Sheet Strength**: With Debt/Equity at **0.6x**, companies have enormous financial flexibility. Even if operating margins compress, the fortress balance sheet provides a cushion to sustain ROE through buybacks—a lever that was simply not available during the leveraged era of the 1990s.
- **Automation is Accelerating**:. While Physical CapEx in *real* terms has barely grown over the last two decades (**Figure 14**), software CapEx has nearly tripled. The "Productivity Wedge" (**Figure 16**) is real—output per worker is detaching from cost per worker, generating a structural margin *expansion* that does not require top-line GDP growth to succeed.
- **Pricing Power is Real**: As **Figure 12** illustrates, Operating Profit margins have broken out to multi-decade highs, confirming that companies are finally playing offense—passing on raw material price inflation rather than just absorbing it.

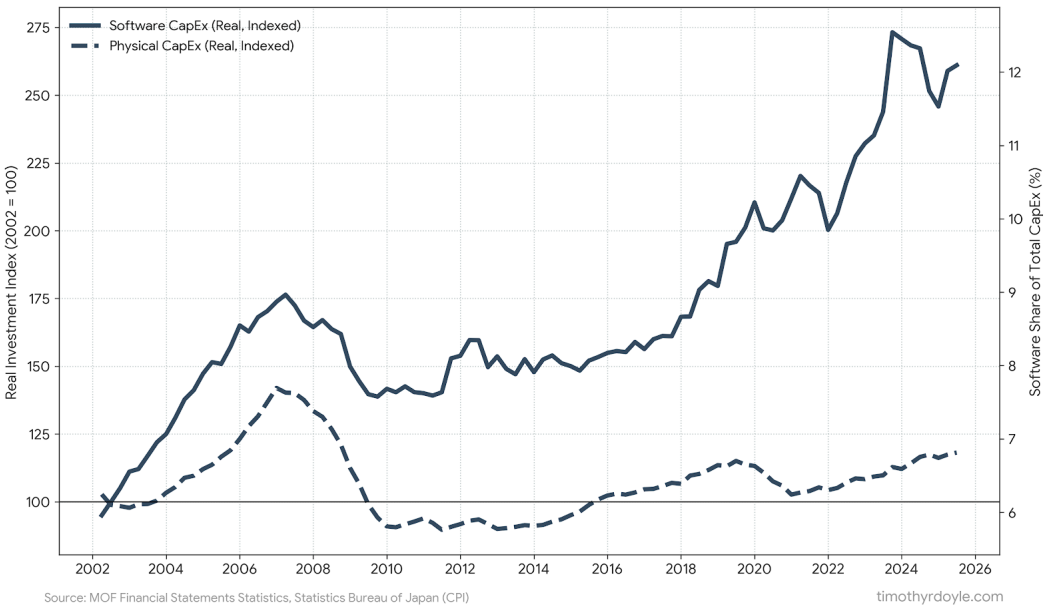
The Base Case Assessment

9% ROE is sustainable if the structural reforms remain in place. The risk is not cyclical reversion—it is policy abandonment. However, a sobering reality remains: 9% ROE is not 15% ROE. Japan Inc. is generating acceptable returns, not exceptional returns. This is why the 19.8x multiple is "fair" but not "cheap".

The Digital Substitution

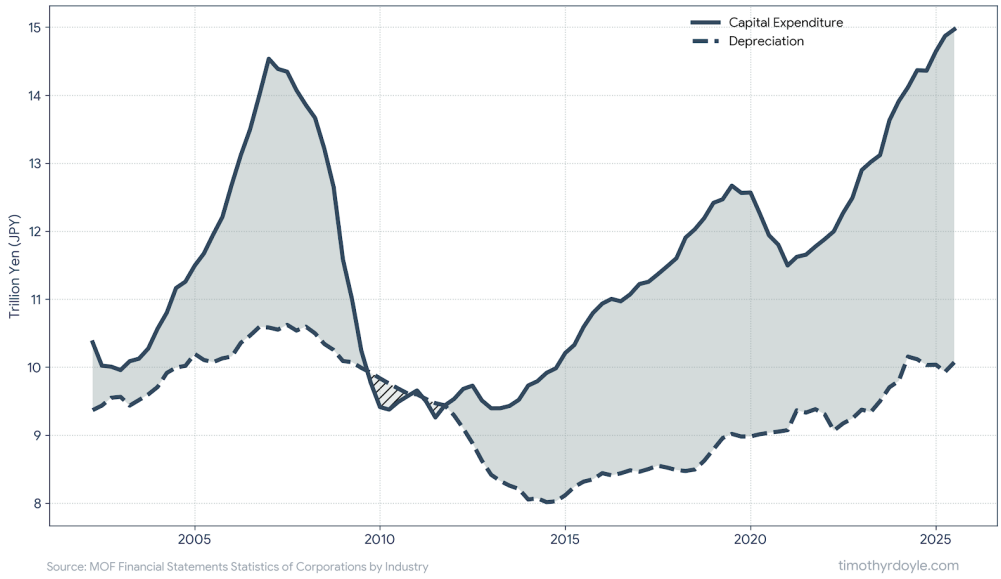
- Software CapEx is growing at an exponential rate (**Figure 14**).

Figure 14: Japan Inc. *Real* SW CapEx & Physical CapEx Growth[20]



- Overall CapEx has accelerated past depreciation (**Figure 15**). Japan is expanding capacity, not managing decline.

Figure 15: Japan Inc. CapEx vs Depreciation[21]



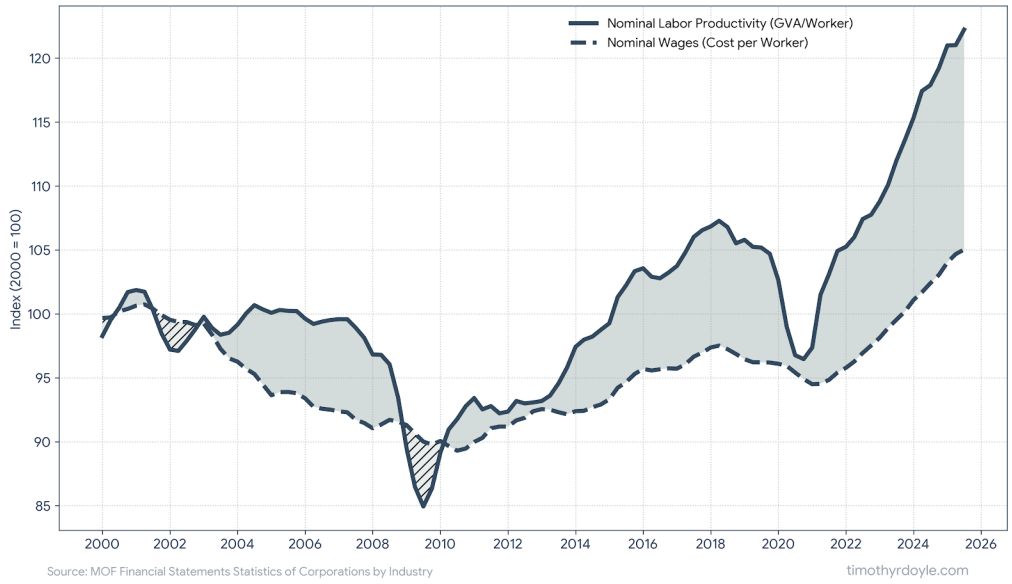
But *where* is this capital going? The data reveals a critical qualitative shift: **Japan Inc. is replacing people with automation.**

The Productivity Wedge

As **Figure 16** illustrates that the above "automation" spending is resulting in higher productivity. Corporations are substituting capital for labor, resulting in value-added per worker rising significantly *faster* than wages.

Companies are using automation to manufacture their own growth, even in a shrinking economy (Figure 6).

Figure 16—The Productivity Wedge (Indexed 2000 = 100)[22]



This automation wave is *deflationary* for unit costs but *inflationary* for margins. However, execution is binary: The *leaders* will expand margins, while the *laggards* will be crushed by labor shortages. This supports the 8% ROE sustainability thesis—but only for companies actually executing on automation. The "average" 8% ROE masks a massive dispersion between the winners and the losers.

The Passive Index Risk

Despite the structural positives, the passive trade is now riskier.

At **19.8x** earnings, the TOPIX is implicitly pricing in a "Goldilocks" scenario. In prior cycles (2006-2007, 2017-2018), aggregate earnings estimates were consistently too optimistic, leading to sharp multiple compression when reality disappointed.

The Asymmetry of Risk

A 9.5% return is acceptable only if valuations remain static. However, if the market re-rates Japan from its current 19.8x back to a historical mid-cycle multiple of 15x, the resulting 25% contraction would be significant.

The Anti-fragile Strategy

Given this asymmetry, the prudent approach is to abandon a binary macro bet as there is no need to predict the yen's direction to generate returns.

A better approach is to target the survivors of the weak yen—a stress test that is already in progress. Dominant companies will gain market share from weaker competitors due to the current difficult domestic operating conditions.

This creates an opportunity across multiple scenarios with no need to predict which ones occur. The asymmetry of risk/reward is already built into each.

I. Weak Yen Moat (Status Quo)

If the yen stays weak (~¥150 or higher), input costs remain high since Japan Inc. are typically net importers of commodities. This is stressful for small competitors that cannot scale. They are forced to cut expenses, reduce inventory breadth, or exit categories entirely to survive. However, for a dominant company with brand equity and pricing power, this environment is an advantage. Dominant companies step into the void left by weakened rivals.

The Result: Dominant companies win via Volume Growth (Market Share Consolidation).

II. Yen Reversion (The Call Option)

If the yen eventually strengthens (to ~¥130 or lower), the math becomes explosive for domestic companies with import commodity exposure. If the yen strengthens, imported input costs collapse, but retail prices remain sticky due to brand inertia and lack of competition.

The Result: Dominant companies win via Margin Explosion (Input costs fall, prices stay high).

III. Interest Rate Hedge (The Fortress Balance Sheet)

The final risk is a spike in JGB yields, which typically crushes equity valuations. Here, the dominant company has a hidden defense: Net Cash.

The Math: For a company with Net Cash equal to 30% of Market Cap, a 200bp rise in rates generates incremental income equivalent to ~7-10% of Pre-Tax Profit. This creates a mathematical floor for earnings that offsets multiple compression.

These scenarios can occur independently or in combination. The anti-fragility lies in positive asymmetry across all three—limited downside in the base case, explosive upside in the variants.

How To Capture Alpha

To execute this, look for companies that are *already* capturing share during the current weak yen environment. Look also for companies possessing pricing power in these tough conditions. Those that capture share while *maintaining* pricing power have a moat.

A Stock Picking Framework

If TOPIX at 19.8x is fairly valued but offers insufficient margin of safety, where should the enterprising investor focus?

The superior strategy: Bypass the index entirely and concentrate in the ignored value cohort where METI reforms provide catalysts and balance sheets provide downside protection.

Portfolio Construction

The following screens are complementary, not mutually exclusive. Adjust based on the opportunity hand or perhaps your conviction in yen reversion—but the framework works because each screen offers different return drivers.

Screen #1: Domestic Compounder

The Thesis: Recession-resistant domestic company using automation to expand margins or capture share. A strengthening yen acts as a massive subsidy to their bottom line.

- **Domestic Focus**: Domestic revenue > 70% AND imported input costs > 30% of COGS (high leverage to yen strength)
- **Automation:** SW CapEx 3-year CAGR > 15%
- **Pricing Power**: Gross margin expansion > 200 bps since 2020 AND absolute gross margin > 30%
- **Valuation**: P/E < 12x
- **Quality**: ROE > 10%
- **Return Driver**: Margin expansion (automation) + input cost deflation (yen reversion)

Screen #2: Bargain Issue

The Thesis: Companies trading below book value with a fortress balance sheet will be coerced by METI/TSE to return capital. Not a bet on earnings growth, but on balance sheet monetization.

- **P/B**: < 1.0x
- **Balance Sheet**: Net cash > 30% of market cap
- **Catalyst**: Total shareholder yield (divs + buybacks) > 4% AND increasing
- **Valuation**: P/E < ROE (implies P/E < 10x)
- **Quality Guardrail**: 5-year average free cash flow > 0
- **Return driver**: METI coerced capital return (buybacks) OR acquisition premium

Risks To Japan Thesis

The overall case for investment in Japan is compelling—but macro, structural, and fundamental tailwinds do not guarantee stock returns. The path to realizing value is obstructed by several risks that can destroy capital if ignored.

The enterprising investor should view these risks as filters in the decision making process. If used correctly, these risks become—counterintuitively—a competitive edge.

1. Macro Volatility (Inflation, Debt, & Currency)

The Risk: Japan faces a "Fiscal Dominance" trap. With public debt at 260% of GDP, the BOJ faces a dilemma: raising rates to fight inflation could spike debt service costs, while moving too slowly risks a currency spiral.

Mitigation: Do not try to predict BOJ policy. Instead, select businesses that can survive the volatility. Equities can function as a superior hedge against fiscal instability, but only if they possess pricing power. If a company cannot maintain gross margins during the current weak-yen stress test, it will not survive the next shock. In an environment of fiscal instability and inflation, equities with pricing power offer better relative protection than bonds or cash —they can grow nominal earnings even as the currency depreciates. Focus on companies with higher gross margins and essential products. If a company dominates its niche, it will grow nominal earnings regardless of the currency or rate environment.

2. The "Value Trap" & Governance Inertia

The Risk: Japanese companies have historically been cheap due to low ROE and poor governance. The risk is that "Old Japan" remains a value trap, or that domestic capital flees overseas rather than supporting the local market.

Mitigation: Look for evidence of change, not just promises. If a company has not increased total shareholder yield (dividends + buybacks) or reduced cross-shareholdings since the advent of the METI reforms in 2023—or initiated any type of shareholder value creation—look elsewhere. Do not just screen for "cheap". Seek management that acts as a partner.

3. Demographic Headwinds

The Risk: Japan's shrinking population is a known structural headwind that could offset capital reallocation gains or lead to a shrinking domestic market.

Mitigation: Screen for automation adoption. Companies increasing Revenue Per Employee while maintaining or expanding margins are building structural moats. Those merely cutting costs are managing decline. Do not just look for those selling the "picks and shovels"; look for those adopting technology to facilitate change. In a labor-shortage economy, the company that creates a "Digital Moat"—while maintaining or expanding revenue with fewer employees—will see its margins expand while its weak competitors' margins contract.

4. Liquidity & Market Structure

The Risk: Many Japanese companies trade at low volumes, making them difficult to enter or exit without moving the price. Furthermore, individual Japanese share prices can exhibit higher month-to-month volatility in comparison to US peers.

Mitigation: For the enterprising investor, this is a *feature*, not a bug. Higher share price volatility provides the opportunity to acquire stocks under intrinsic value. The liquidity constraint is solved through patience and mechanics: use algorithmic execution to build positions steadily without driving up the entry price. Treat these limitations as a barrier to entry that keeps competition low and valuations attractive.

Conclusion

The mobilization of ¥1700 Trillion is not a hypothesis—it is observable. Capital is flowing. Margins are expanding. ROE has broken above 8%. But at 19.8x, the TOPIX prices in sustained excellence with almost zero margin of safety. The opportunity lies where the index cannot follow: profitable companies trading below book value, and recession-resistant compounders serving domestic demand—both offering margin of safety the TOPIX no longer provides.

Realizing this value is a three, five, or perhaps even a ten year thesis as capital reallocation and margin expansion continue to compound slowly—but persistently. The patient investor willing to endure volatility will be rewarded as the market reprices structural moats it currently ignores.

Do not treat Japan as a macro trade. It is a stock picker's market where the macro tailwinds are structural and impactful—on a company by company basis. The index appears to have largely priced these factors in, but individual security prices that lack the passive flows do not yet appear to completely reflect the ¥1700 Trillion mobilization of investment capital that is taking place.

About the Author: Timothy R. Doyle is a private investor and researcher focused on value investing principles and quantitative market analysis.

Appendix A: The Nikkei 225 Distortion—A House of Mirrors

As a price-weighted index, the N225 gives disproportionate weighting to share price regardless of economic footprint. This creates two critical structural failings: an extreme concentration driven by idiosyncratic price action, and a fundamental misrepresentation of the companies actually driving the economy. The index is a house of mirrors: high-priced outliers distort the index level, while the core companies—the true backbone of the Japanese economy—are largely ignored.

Ironically, for a nation defined by precision, the Nikkei 225 relies on an archaic price-weighting methodology that distorts economic reality.

1989 N225 Market Structure

A look at the composition of the N225 index at bubble height reveals how skewed it was. Throughout the 1970s and 1980s, Japanese banks were the primary conduit for funding Japan Inc. The higher leverage present on Japan Inc. balance sheets was a direct result of this lending boom.

By 1989, the top ten companies by market capitalization (see below) represented approximately ¥102.4 Trillion, or roughly 17.3% of the total market value of the TSE First Section. These companies were almost entirely domestic focused, infrastructure, and financial firms. By this stage, these entities were massive and highly levered. Their valuations were predicated on the massive latent profits of their own stock portfolios—through cross shareholdings— and their real estate holdings.

1989 Top 10 Japanese Companies by Market Cap:

Rank	Company	Sector	Market Cap (¥ Trillion)	Market Cap %	Index Weight %
1	**Industrial Bank of Japan**	Banking	¥15.9	2.6%	0.4%
2	**Sumitomo Bank**	Banking	¥10.5	1.7%	0.3%
3	**Fuji Bank**	Banking	¥9.9	1.6%	0.3%
4	**Dai-Ichi Kangyo Bank**	Banking	¥9.1	1.5%	0.3%
5	**Mitsubishi Bank**	Banking	¥9.1	1.5%	0.3%
6	**Tokyo Electric Power**	Utilities	¥7.2	1.2%	0.5%
7	**Sanwa Bank**	Banking	¥7.1	1.2%	0.3%
8	**Nippon Telegraph & Tel.**	Telecom	¥23.0	3.8%	0%
9	**Toyota Motor**	Automotive	¥7.7	1.3%	0.2%
10	**Nomura Securities**	Financials	¥6.7	1.1%	0.3%
TOTAL			**¥102.4**	**17.3%**	**2.9%**

Despite the market being driven largely by financial engineering, the N225 index itself reflected a completely different Japan. Not a single name among the top ten index weighted companies (below) represented even 1/225 of the overall Nikkei market cap. These ten companies—with

less than 1.5% of total economic influence—commanded nearly one-third of the price movement of the entire index.

1989 Top 10 Japanese Companies by N225 Index Weight:

Rank	Company	Sector	Market Cap (¥ Trillion)	Market Cap %	Index Weight %
1	**Yoshihara Oil Mill**	Cooking Oil	¥0.09	0.015%	3.8%
2	**Katakura Industries**	Textile	¥0.14	0.024%	2.7%
3	**Teikoku Oil**	Oil & Gas	¥1.05	0.17%	2.4%
4	**Sony Corp**	Electronics	¥2.60	0.43%	5.5%
5	**TDK Corp**	Electronics	¥0.74	0.12%	3.5%
6	**Kyocera**	Electronics	¥0.96	0.16%	3.2%
7	**Fanuc**	Automation	¥1.45	0.24%	3.9%
8	**Toho Zinc**	Metals	¥0.21	0.03%	2.2%
9	**Shin-Etsu Chemical**	Chemicals	¥1.10	0.18%	2.3%
10	**Japan Radio**	Electronics	¥0.45	0.07%	2.0%
TOTAL			**¥8.79**	**1.45%**	**31.5%**

The N225 of 1989 was more a measurement of speculative small-cap price action rather than the value of the banking sector, the actual driver of the Japan economy of the 1980s. Companies like Yoshihara Oil Mill and Katakura Industries—which were economically insignificant—held greater sway over the index's performance than the massive banks that were the primary conduit for funding Japan's stellar growth of the 1970s and 1980s. This distortion masked the overvaluation of the broader market while emphasizing the volatility of minor industrial players.

In spite of the distortion created by how the 1989 N225 index was constructed, it is still clear to see that—by the end of 1989—the companies as a whole that made up the entire market were trading at high valuations and were highly levered. While these two factors were the underpinnings, the clear indicator that the entire market was overvalued was the relationship between the market earnings yield and the risk-free yield. Investors were willing to pay nearly four times more for risky assets (stocks) than they were willing to pay for holding risk-free bonds (10-yr JGB). This alone should have been enough to signal that **the Nikkei 225 of 1989—especially since it provided an ever further mathematical distortion of an already expensive market—was never a good "risk-on" trade.**

The 2026 N225 Market Structure

By 2026, the top ten companies by market capitalization (below) represent approximately ¥239.3 Trillion, or roughly 23.4% of the total market value of the TSE market. These companies are more globally focused, technology, and financial firms.

The N225 has transformed from a domestic banking index into a basket of global industrial and technology powerhouses. Much of their wealth extends beyond Japan's borders.

2026 Top 10 Japanese Companies by Market Cap:

Rank	Company	Sector	Market Cap (¥ Trillion)	Market Cap %	Index Weight %
1	**Toyota Motor**	Automotive	¥45.9	4.5%	1.1%
2	**Mitsubishi UFJ Fin.**	Banking	¥31.9	3.1%	1.0%
3	**SoftBank Group**	Tech/Invest	¥24.2	2.4%	8.3%
4	**Hitachi**	Industrial	¥24.1	2.4%	1.5%
5	**Sumitomo Mitsui Fin.**	Banking	¥20.8	2.0%	1.0%
6	**Sony Group**	Cons Disc.	¥20.5	2.0%	1.0%
7	**Tokyo Electron**	Semicond.	¥18.9	1.9%	5.9%
8	**Advantest**	Semicond.	¥18.5	1.8%	13.0%
9	**Fast Retailing**	Retail	¥18.0	1.8%	8.0%
10	**Mizuho Fin. Group**	Banking	¥16.5	1.6%	1.0%
TOTAL			**¥239.3**	**23.4%**	**40%**

The 2026 N225 is even more distorted than 1989. The top ten companies fully comprise 46.5% of the index weighting. Of these ten, three are tech/semiconductor focused companies that account for 27% of the index weighting while only representing 6.1% of the economy. While four companies appear on both "top ten" lists—unlike the zero overlap of 1989—the weighting mismatch remains egregious. The overlap suggests alignment, but the math enforces distortion.

2026 Top 10 Japanese Companies by N225 Index Weight:

Rank	Company	Sector	Market Cap (¥ Trillion)	Market Cap %	Index Weight %
1	**Advantest**	Semicond.	¥18.5	1.8%	13.0%
2	**SoftBank Group**	Tech/Invest	¥24.2	2.4%	8.3%
3	**Fast Retailing**	Retail	¥18.0	1.8%	8.0%
4	**Tokyo Electron**	Semicond.	¥18.9	1.9%	5.9%
5	**TDK Corporation**	Electronics	¥4.8	0.5%	2.4%
6	**KDDI**	Telecom	¥10.5	1.0%	2.1%
7	**Shin-Etsu Chemical**	Chemicals	¥13.5	1.3%	1.8%
8	**Recruit Holdings**	Services	¥11.2	1.1%	1.8%
9	**Konami Group**	Entertainment	¥2.4	0.2%	1.6%
10	**Fanuc**	Automation	¥6.5	0.6%	1.6%
TOTAL			**¥128.6**	**12.6%**	**46.5%**

Over 36 years after the Japan bubble, **the 2026 N225 index—with ten companies alone comprising nearly 50% of the index weight (three are tech/semiconductor focused companies representing 27% of the index)—is now even *more* concentrated than the US Nasdaq 100, where price is driven by the highly volatile US technology sector.** The Nikkei 225 is anything but a broad measure of the Japanese economy. Relying on this narrow and distorted lens to value Japan Inc. is dangerously flawed.

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[2] **Figure 1:** Japan BOJ Policy Rate vs Japan CPI - BOJ policy rate sourced from boj.or.jp/en/statistics; Japan CPI sourced from stat.go.jp/english/data/cpi

[3] **Figure 2:** US Fed Funds Rate vs US CPI - Sourced from FRED FEDFUNDS; US CPI sourced from FRED CPIAUCSL

[4] **Figure 3**: The Big Mac Index - *The Economist* Magazine- Sourced from https://github.com/TheEconomist/big-mac-data/source-data

[5] **Figure 4**: JPY per USD PPP Estimate - Source: PPP conversion factor, Consumption (Local Currency Unit per $) data.worldbank.org; Source: PPP conversion factor, GDP (Local Currency Unit per $) PWT version 11.0; Source: JPY to USD Spot Exchange Rate (AEXJPUS) FRED

[6] **Figure 5:** Big Mac Index Real Pricing Power - normalized by: US CPI from U.S. Bureau of Labor Statistics at bls.gov/cpi/; Japan CPI at e-Stat.go.jp

[7] **Figure 6:** Rising Nominal Wages - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry*: Salaries - sheet 55; Bonuses - sheet 56; Employees - sheet 59; Complete Ministry of Finance Raw data set available at: https://www.mof.go.jp/english/pri/reference/ssc/historical.htm. (sheets 1 thru 70)

[8] **Figure 7:** Japan Household Wealth in Nominal Terms - Annual Report on National Accounts for 2024; Department of National Accounts, Economic and Social Research Institute, Cabinet Office, Government of Japan - Table 5: Closing Stocks of Assets and Liabilities of Households; available at https://www.esri.cao.go.jp/en/sna/menu.html

[9] **Figure 8:** Japan Household Wealth in Real Terms - Annual Report on National Accounts for 2024; Department of National Accounts, Economic and Social Research Institute, Cabinet Office, Government of Japan - Table 5: Closing Stocks of Assets and Liabilities of Households; available at https://www.esri.cao.go.jp/en/sna/menu.html; Data normalized by Japan CPI

[10] **Figure 9:** Japan Corporate "Value Vault" Liquidity - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry:* Cash - sheet 2; Securities - sheet 8; Investment Securities - sheet 21

[11] Takata, Hajime. "Economic Activity, Prices, and Monetary Policy in Japan: Japan as a Leading Asset Management Center." Speech at the Meeting of the Chugoku Economic Federation, Hiroshima. Bank of Japan, October 20, 2025. Available at: https://www.bis.org/review/r251105k.pdf.

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[13] Ibid

[14] Yamaji, Hiromi. "Corporate Governance Reform 2025" - Presentation by the Group CEO, Japan Exchange Group, Inc., at the Foreign Correspondents' Club of Japan, November 4, 2025. (via YouTube)

[15] **Figure 10:** Fortress Balance Sheet - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry:* Cash - sheet 2; Net Assets - sheet 35; Retained Earnings - sheet 39; ST Debt - sheet 25; LT Debt - sheet 31; Bonds - sheet 30

[16] **Figure 11:** Japanese Gross Profit Margins - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry:* Sales - sheet 45; Cost of Sales - sheet 46

[17] **Figure 12:** Ordinary Profits Breakout - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry:* Sales - sheet 45; Cost of Sales - sheet 46

[18] Graham, Benjamin. Statement on Factors Affecting the Buying and Selling of Equity Securities. Hearings Before the Committee on Banking and Currency, United States Senate, 84th Congress, 1st Session. Washington D.C., March 11, 1955, p. 545.

[19] **Figure 13:** Real Net ROE for Japan Inc. - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry:* Ordinary Profit - sheet 53; Net Assets - sheet 35; Effective tax rate assumptions: Before 1998 50%, thru 2012 40%; thru 2016 35%; onward 30%

[20] **Figure 14:** Japan Inc. SW CapEx Growth - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry:* CapEx - sheet 60; Software CapEx - sheet 61; Plant & Equipment Excluding Software - sheet 62

[21] **Figure 15:** CapEx vs. Depreciation - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry:* CapEx - sheet 60; Depreciation - sheet 20

[22] **Figure 16:** The Productivity Wedge - Derived from Ministry of Finance, *Financial Statements Statistics of Corporations by Industry* (Historical Data). Calculated using the summation method for Gross Value Added (GVA): *Operating Profit* + *Personnel Expenses* + *Depreciation Expenses*. **Productivity** is defined as GVA per employee; **Compensation** is defined as Personnel Expenses per employee. Data encompasses "All Industries (excluding Finance and Insurance)" to isolate the real economy.